shipping feature

French financiers weigh up change in tax leasing rules

Recent changes in French tax law have put the onus on banks and shipping companies to apply the rules, which may lead to more transactions writes Barry Parker

A fresh buzz has arisen among French financial institutions eagerly awaiting regulations on the treatment of tax leases that will be emerging from Paris.

Historically, deals had been done from the inception of French tax leasing in the late 1990s, until December 2004 when the European Commission (EC) challenged French tax leasing, citing a potential incompatibility with EC rules.

In the maritime markets, both cruiseships and containerships had been leased to French entities, while cross-border deals had been done for Swedish tanker operators.

A memorandum from the Paris office of law firm Watson Farley & Williams discusses provisions within the 'Amended Financial Bill of 2006', adopted late last year, which will now potentially pave the way for more French tax lease transactions. According to Watson Farley, no new transactions can be consummated until the French tax authorities provide 'official comments' on exactly how the new rules will be applied, along with a decree stipulating the conditions for applying the new rules. These are expected by the end of April.

Self-regulation

Gilles Cervoni, a Paris-based partner at the law firm, tells *Jane's* that going forward, new transactions will not require pre-approval from the French government and that "banks and shipping companies would need to make their own judgements", on the correct application of rules. He tells *Jane's* that the pace of French activity could likely quicken, with a liberalisation of previous requirements that vessels be operated in France or built in French shipyards.

Jean-Marc Zampa, a Paris-based partner at law firm Orrick Rambaud Martel, responding to a question concerning the likelihood of preferences being given to shipping under pending French rules, tells *Jane's*: "The new French tax regime [article 39C of the Code Général des Impôts] can allow shipowners to optimise their asset financing in a significant way."

The Watson Farley memorandum does outline what is known: the lease will allow a financial lessor to gain tax benefits of ownership, by frontloading depreciation benefits (capital allowances). Meantime, the lessee, often "a trading company that cannot use the capital allowances because of insufficient available profits", gains "nearly all the risks and rewards of ownership of that asset".

As with other tax-driven leases, the lessor sees a big tax shield in the early years of the lease and benefits are shared with the charterer of maritime assets in the form of lower hire payments on a bareboat charter. Likely changes will relate to the treatment of depreciation by the owning entity — société en nom collectif (SNC) — as well as the mechanics of timing deductions.

The treatment of capital gains, when assets are sold, is also up for review.

Under the old French rules, capital gains were exempt from taxation when assets were sold; under the new regime, a tax recapture is likely at the level of individual members of an SNC. However, Watson Farley indicates that the recapture may be avoided through a transfer of SNC shares. Where ships are operated under the French tonnage tax regime, gains on the sale may be partially exempt from the capital gains tax.

The proposed treatment of capital gains shows just how closely the new rules are aligned with commercial dynamics. Many companies are not industrial shipping players and may wish to reconfigure their equipment portfolios.

There is also a move to rekindle the French shipping industry. SNC taxation will be apportioned according to the time that a vessel has been inside the tonnage tax regime (no tax) and outside the scheme (tax at the corporate rate). Watson Farley points out that the old rules stipulated the use of accelerated depreciation and required a minimum of eight years under the French flag.

Now "the new rules do not impose any conditions relating to the length or type (normal or accelerated) of depreciation used", according to the memorandum.

Law firm Orrick has acted in several big deals in the French market, in the container and the cruise sectors. The container transaction involved the large French container line CMA-CGM.

> *"We need to mobilise for harmonisation of tax measures in the construction sector"*
>
> **Jean-Marc Zampa**
> Orrick Rambaud Martel

In the fourth quarter of 2004, mandated lead arranger Calyon, advised by Orrick, put together a USD750 million French tax lease partially funded by the Export-Import Bank of Korea (Kexim). Proceeds were used to finance construction of eight 6,800 teu vessels. Kexim senior debt was complemented by additional loans from a consortium of shipping banks that included BNP Paribas and Caisses d'Epargnes (CNCEP). Zampa comments: "This was the first time a structure combined export finance and a French tax lease under article 39 CA [now abolished]."

In the late 1990s, structured tax-driven leasing transactions were also put in place for three smaller cruiseships built at Chantiers de Atlantique — acquired by Alstom and now in the hands of Aker — with Calyon also in the lead. In a 2005 deal that included an export credit, Orrick advised a bank syndicate that was structuring a French tax lease on two cruiseships built for Mediterranean Shipping (MSC) at the same French yard.

Under the emerging rules, Watson

Springtime for tax leasing

Highly structured tax leasing is set to emerge from its hibernation status in France. As reported in *Jane's*, Société Générale recently completed a EUR100 million (USD134 million) cross-border leveraged lease of double-decker commuter railcars for New Jersey Transit (NJT), the commuter rail service of the US state of New Jersey. The carriages, to be delivered later this year from Bombardier, will serve crowded lines feeding passengers into New York's Pennsylvania Station.

Robert Webb, NJT's project finance manager, tells *Jane's*: "We have done a number of cross-border leases in the French and the Swedish markets." But, in describing this French lease, he cautions that "there is not a lengthy process of comparison; if some money comes along, you grab it. These are really very much niche deals".

More typically, NJT's funding for equipment comes from advances from the state of New Jersey, funded, in turn, by appropriations from the state or from bond issuance, or from leases involving the regional Metropolitan Transportation Authority or from the bi-state Port Authority of New York & New Jersey.

In fact, the French deal is something of an anomaly. Steve Millman, a partner with law firm Watson Farley & Williams, who acted for Société Générale, lessor in the leveraged transaction, provides a broader context. He emphasises that NJT, as a tax-exempt entity, does not generate tax losses for a US lessor. He comments: "Sometimes, you may see tax-exempt entities [such as] NJT engage in a pure financing, where they own the equipment at the end of the term, but there is no tax angle for US equity lessors." Millman says legislative changes have limited the leasing alternatives available to NJT, but that potential foreign deals could see terms of at least a 15-year duration, and very often, the lessee can exercise an attractively priced call option at the end of the term. A NJT press release from the 2006 fiscal year highlights the unusual role of cross-border leases. "In addition to fare increases the corporation is optimistic that it will be able to generate USD3.2 million in revenue by executing one more cross-border leveraged lease transaction, which is permitted under a grandfather provision in the new federal ban on such financial transactions."

Farley points out that the nexus for qualifying assets — which might be ships, aircraft and even power generating equipment — will be widened to include countries that are members of the European Economic Area (EU members plus Norway and Iceland) and have entered into a double tax treaty with France. Watson Farley's Cervoni adds: "These new rules could benefit other transport areas beyond shipping. We have not yet explored how they could be applied to cross-border transactions."

Brostrom AB is a company operating vessels built in Croatia and China from an office in Paris. Brostrom has utilised French tax leases. The Swedish oil products and chemicals transporter has recently been in the financial news with a SEK500 million (USD71 million) three-year bond deal, carrying a 5.25 per cent coupon, solely arranged by SEB Merchant Banking. The company points to this recent bond issue, launched on 20 March 2007 — its second deal in two years — as part of a long-term financing strategy.

Brostrom has also been an innovator on the leasing front. In the mid-1990s, it was one of the few shipping companies to actually enter into lengthy Pickle leases with a US lessor in a three-ship deal financed under this structure. The lease runs until 2012.

In 2001 and 2002, Brostrom's majority-owned French subsidiary entered into bareboat charters under French tax leases on five Far Eastern-built 37,000 tonne product tankers. Brostrom accounts for the transactions as finance leases on the vessels, which trade in European waters and are operated under the French tonnage tax regime. Three of these chemical tankers, built in a Chinese yard, were booked into a French lease worth USD102 million in late 2004 in a deal lead arranged by BNP Paribas.

The bank also arranged two tranches of shipping debt from the Scandinavian market — where Brostrom has close ties with SEB and other financial institutions — to fund the deal.

National interest

As the tax benefits have reduced after several years, Brostrom has exercised purchase options on at least one of the 2001-built vessels bringing it on balance sheet. However, under the old lease terms the vessels must remain under the French flag for at least eight years for favourable tax treatment to be recognised.

Flexibility in the new French rules is congruent with other industry forces. In very cautious accounting treatment, the listed Swedish tanker operator currently maintains an accounting reserve for potential recapture of French tax benefits, which will fully amortise, declining to zero after eight years. Brostrom has been a consolidator, buying out vessels from such partners as Iverships, as the company brands itself as a logistics player. Yet, it could have gone the other way; under the new French rules, a lessee would not be gripped by an eight-year straightjacket.

Tax leasing for shipping reached a zenith in 2004, according to the industry overview section of the recent First Ship Lease Singapore Trust (FSL) prospectus.

The French case, in a market described, along with those of Korea and Holland, as "comparatively small" is nonetheless illustrative of the road back for tax-driven leasing within EU countries, after the EU challenged rules in individual jurisdictions.

"These new rules could benefit other transport areas beyond shipping"

Gilles Cervoni
Watson Farley
& Williams

Orrick partner Zampa refers to the need for a single set of rules, telling *Jane's*: "We now need to mobilise for the harmonisation of tax measures in the maritime and naval construction sector — in other words, harmonisation of tax rules applicable to financing, to the taxation of the business of shipowners, to naval construction yards and the rules applicable to international flags." While certain leasing structures (such as the KG) have suffered due to high asset prices, FSL's prospectus suggests that the capital conservation inherent in leasing would be an important driver of new business. ■

Related story

Untapped finance: is Spain ready for tax-based leasing?, 2 November 2006

Visit jtf.janes.com to access this story